Internal Revenue Service

memorandum

CC:TL-N-3316-90
Br1:HFRogers

date: FEB 2 3 1990

to: District Counsel, San Diego CC:SD
Attn: Margaret K. Hebert

from: Assistant Chief Counsel (Tax Litigation) CC:TL

---

subject: [redacted] v. Commissioner
Dkt. No. [redacted]
T.C. Memo. 1990-4

This is in response to your request for tax litigation advice dated January 31, 1990.

ISSUE

Whether the petitioners are entitled to use the installment method of reporting income when they had previously improperly reported their income from the sale contracts. 0453-0100; 0453-030; 0453-0600; 0453-1000.

CONCLUSION

The petitioners are not entitled to retroactively elect to use the installment method of reporting income from sales.

FACTS

[redacted] owned and operated a business that sold [redacted] repair equipment. [redacted]'s business was conducted as a sole proprietorship doing business as [redacted].

[redacted] sold automotive repair equipment to customers on a cash and charge basis. [redacted] also sold equipment to customers under what [redacted] referred to as a lease/sale program, but which was in actuality a deferred purchase program. The court found the lease/sale transactions were treated by [redacted] and by [redacted] as sales.

The charge transactions were properly reported on the accrual basis. The lease/sale transactions were impermissibly accounted for on the cash method.

09280

The Tax Court found that the petitioners substantially underreported their income in [redacted] through [redacted]. The petitioners raised for the first time on brief the issue that they were entitled to elect the installment method of reporting [redacted]'s lease/sale income.

DISCUSSION

I.R.C. § 453 provides an accounting method whereby taxpayers who dispose of certain types of property under prescribed deferred payment conditions may report, for federal income tax purposes, any profit or gain generated thereby in those years in which payments attributable to the obligations of the purchaser are received. Before the Installment Sales Act of 1980, all installment method rules were found in section 453.

In 1980, section 453A was promulgated providing special rules for dealers in personal property. In 1986, several substantive changes were made to section 453A. In 1987, dealers in personal property were prohibited from using the installment method.

In the instant case, the tax years at issue are [redacted] through [redacted]. Therefore, the applicable Code provision is section 453A because [redacted] is a dealer in personal property. To qualify sales under an installment plan under the installment method, the property sold or disposed of must be personalty which is regarded as inventory by the dealer. This test is met in the instant case. Thus, pursuant to section 453A, those who regularly sell or otherwise dispose of personal property on an installment plan may report the income derived therefrom in the taxable year in which the payments arising from that disposition are received.

If he qualified, a dealer could elect the installment method for the first year in which sales under an installment plan are made without obtaining the permission of the Commissioner. Treas. Reg. § 1.453-7(a); Prop. Treas. Reg. § 1.453A-3(c). The election to adopt the installment method had to be made on the income tax return for the taxable year of the election, filed on or before the time specified (including extensions) for filing such return. Treas. Reg. § 1.453-8(a)(1); Prop. Treas. Reg. § 1.453A-3(b)(1).

An accrual method taxpayer could also change from the accrual to the installment method. Section 453(c), permitting such a change, was eliminated from the Code in 1980. However, the legislative history demonstrates this change was not intended as a withdrawal of the opportunity to make the change, but rather was to eliminate the adjustment procedure required under section 453(c)(2). S. Rep. No. 1000, 96th Cong., 2d Sess. 25(1980).

According to the legislative history to the Installment Sales Act of 1980, "an accrual method dealer who elects the installment method of reporting will report gain as payments are received only for sales made on or after the effective date of the installment method election." S. Rep. No. 1000 at 25. The election does not require the consent of the Commissioner. Prop. Treas. Reg. § 1.453A-3(c). The election would apply only with respect to changes made on or after the first day of the taxable year of change; payments received on or after the effective date of change on account of sales made in a prior year are accounted for under the method of accounting in use in the prior year. Prop. Treas. Reg. § 1.453A-3(d).

The legislative history to the 1980 Act further states that "a failure to report the full amount of gain from sales may be treated as an election of the installment method." S. Rep. No. 1000 at 25. This provision comes from a portion of the Senate report dealing with the election of the installment method by accrual basis taxpayers. By way of example, the Senate report states:

> [I]t is intended that a dealer who treats a transaction as a lease of personal property and only reports the payments received as rental income, may be eligible for installment reporting under the regulations if the transaction is recharacterized as a sale rather than a lease in an audit by the Internal Revenue Service.

S. Rep. No. 1000 at 25. Under the proposed regulations, such a recharacterization is deemed to constitute an election of the installment method. Prop. Treas. Reg. § 1.453A-3(b)(4).

This result is in accord with prior case law. In Sundance Ranches, Inc. v. Commissioner, T.C. Memo. 1988-535, the Tax Court had an opportunity to determine if a taxpayer could retroactively elect the installment method. The Tax Court summarized therein the law relating to belated elections of the installment method. As the Tax Court found:

> During the years in issue, section 453(b) required taxpayers to affirmatively elect to use the installment method for reporting gains from sales of real property. . . . In cases where a sale was reported on a return under a valid method inconsistent with installment reporting, later election of the installment method was precluded. In cases in which a transaction was recorded in some fashion on a return but was erroneously categorized as something other than a sale,

> the taxpayer's method of reporting gain was held to be not binding. See, e.g., Mamula v. Commissioner, 346 F.2d 1016 (9th Cir. 1965). In cases where no payment was received in the year of sale, an election was permitted by an amended or late return. (Citations omitted).

Sundance Ranches, 56 T.C.M. (CCH) at 703.

Thus, the recharacterization language in the Senate report is consistent with the line of cases under Mamula. Under this rationale, the taxpayer reported the sale as a lease so the taxpayer's method of reporting gain is not binding. It should be noted that the 1980 Act changed the installment method rules so that now taxpayers have to elect out of this method.

Attached to your January 31, 1990, memorandum requesting tax litigation advice was a copy of the revenue agent's opinion. The revenue agent's opinion correctly notes that the petitioner in the instant case never treated the sales as leases. In this regard the Tax Court made a finding of fact that the "lease/sale transactions were treated by [redacted] and by petitioner as sale transaction. They were not treated as leases." Slip op. at 5. We agree that this indicates that the installment method cannot now be elected by the petitioner; however, we would caution that the recharacterization is only an example and may not be the only manner in which the taxpayer can later elect the installment method.

The analysis in Mamula may be helpful in the instant case. In Mamula, the taxpayer reported profit from his sale of real estate properties on the deferred payment method. The Tax Court and the Ninth Circuit both concluded that the deferred payment method was an impermissible method of accounting. The Ninth Circuit held that the taxpayer could not be bound by his choice of accounting method because it was an impermissible method.

Similarly, in the instant case, the petitioners used the cash method of reporting the lease/sale transaction. The cash method was impermissible. Under the rationale in Mamula, the petitioners may attempt to argue that they are entitled to use the installment method rather than reporting the gain in full in the year of sale.

However, it should be noted that the Ninth Circuit in Mamula held that the taxpayers used the impermissible method of accounting in good faith and made a full disclosure of the transactions in the year of sale. There is insufficient evidence for us to determine if the petitioners used the cash method in good faith but, based on the factual findings made by the court, we believe the court could find that this prong was met.

In the instant case, the Tax Court found that the underreporting of approximately $[redacted] of income over [redacted] years was due to fraud. Slip op. at 21. The Tax Court also found that portions of payments received on the lease/sale transactions were not recorded or were recorded as credits or reductions to accounts receivable. Therefore, it is unlikely that the court will conclude that there was full disclosure of the transactions in the year of sale. The Tax Court noted the importance of this element in allowing late elections of the installment method in Sundance Ranches.

We believe that the Tax Court should find in this case, as it did in Sundance Ranches that:

> We are not persuaded that petitioner is entitled to the benefit of rules applicable to taxpayers who report a transaction at the time payment is received, advance a method of accounting in good faith, and later concede it to have been improper. Petitioner in this case is more in the position of a taxpayer who attempts to use hindsight to correct an unfortunate choice of reporting or who deliberately attempts to shift the tax consequences of sales. Petitioner is not entitled to now elect the installment method of reporting. (Citations omitted).

Sundance Ranches, 56 T.C.M. (CCH) at 703.

Thus, we concur with the conclusion stated in your request for tax litigation advice. The petitioners are not entitled to use the installment method of reporting income from the lease/sales transactions.

If you have any further questions, please contact Helen Rogers at FTS 566-3442.

MARLENE GROSS

By: Gerald M. Horan

GERALD M. HORAN
Senior Technician Reviewer
Branch No. 1
Tax Litigation Division